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## Accounting Firm or Guarantor - The Third Circuit's Answer to Rule 10b-5's Scienter Requirement in Accountant Liability Cases

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# ACCOUNTING FIRM OR GUARANTOR? THE THIRD CIRCUIT'S ANSWER TO RULE 10b-5'S SCIENTER REQUIREMENT IN ACCOUNTANT LIABILITY CASES

## I. INTRODUCTION

While accounting firms are supposed to act as the watchdogs of the marketplace, ensuring confidence in and lending stability to the companies that drive our economy, the reality is much less awe-inspiring.<sup>1</sup> In the past year, Arthur Andersen ("Andersen"), the previously well-regarded accounting firm, has gone down in infamy.<sup>2</sup> Together with many other well-publicized debacles by accounting industry giants, the industry has become the securities fraud scapegoat, whether deserving or not.<sup>3</sup>

Nevertheless, well before Andersen became infamous for paper shredding, the Securities and Exchange Commission ("SEC") instituted the Securities Exchange Act of 1934<sup>4</sup> ("Exchange Act") to protect investors from the fraudulent practices that have become all too prevalent in today's securities markets.<sup>5</sup> Section 10(b)<sup>6</sup> of the Exchange Act combined with SEC

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1. See generally Julie Faussie, Note, *Limiting Liability in Public Accounting Suits: A Desperate Appeal from a Beleaguered Profession*, 28 VAL. U. L. REV. 1041 (1994) (discussing economic and commercial realities that limit accountants); see also *Bily v. Arthur Young & Co.*, 834 P.2d 745, 762 (Cal. 1992) ("An auditor is a watchdog, not a bloodhound.").

2. See generally *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002) (discussing Andersen).

3. See Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 BUS. LAW. 143, 175 n.139 (2002) ("The blizzard of accounting and related scandals following Enron and Andersen suggests the breadth of the problem: Adelphia, CMS Energy, Dynegy, Merrill Lynch, Tyco, WorldCom, Xerox.").

4. 15 U.S.C. § 78(a) (1997).

5. See S. REP. NO. 792, at 1-5 (1934) (noting that 1934 Act was intended to protect investors against manipulation of stock prices by, in part, imposing regular reporting requirements on companies whose stock is listed on national securities exchanges).

6. See 15 U.S.C. § 78j(b) (1994) (addressing manipulative and deceptive practices). Section 10(b) of the 1934 Act states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sales of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe.

*Id.*

Rule 10b-5<sup>7</sup> are the prime weapons against securities fraud.<sup>8</sup> One of the five basic elements required to state a valid cause of action under Section 10(b) and Rule 10b-5 is scienter.<sup>9</sup> Over twenty-five years ago, the Supreme Court defined scienter in the securities fraud context as “a mental state embracing intent to deceive, manipulate, or defraud.”<sup>10</sup>

In 2002, the United States Court of Appeals for the Third Circuit undertook the issue of scienter in *In re Ikon Office Solutions, Inc. Securities Litigation*.<sup>11</sup> There, the shareholders of Ikon Office Solutions, Inc. (“Ikon”) brought a class action suit against Ikon’s auditor, Ernst & Young LLP (“Ernst”), claiming a Section 10(b) violation.<sup>12</sup> Ernst defended on the ground that it lacked scienter, one of the elements of a Section 10(b) violation, and because this element was missing, it could not be liable.<sup>13</sup> In addressing the issue of Ernst’s scienter, the court established a “demanding threshold,” holding that to find Section 10(b) liability for fraud “the mere second-guessing of calculations will not suffice.”<sup>14</sup> Instead, the plaintiffs must demonstrate that the accountant’s judgment was so egregious that “a reasonable accountant reviewing the facts and figures should

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7. See 17 C.F.R. § 240.10b-5 (1999) (serving as general anti-fraud provision in federal security laws). Casting the law in similar terms as Section 10(b), SEC Rule 10b-5 reads as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

*Id.*

8. See Scott J. Davis, *Liability Under Sections 10, 18 and 20 of the Securities Exchange Act of 1934*, in UNDERSTANDING THE SECURITIES LAW 723, 729 (2000) (explaining Rule 10b-5’s role in 1934 Act).

9. See 17 C.F.R. § 240.10b-5 (1999) (setting forth statute provisions); 15 U.S.C. § 78j(b) (1994) (setting forth statute provisions).

10. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (holding that scienter is essential element of any private claim under Rule 10b-5); see also *Aaron v. SEC*, 446 U.S. 680, 691 (1980) (holding that scienter is required element of any SEC action under Rule 10b-5).

11. 277 F.3d 658 (3d Cir. 2002).

12. See *id.* at 662 (setting forth facts of case). For a further discussion of *Ikon*’s facts and procedural history, see *infra* notes 104-24 and accompanying text.

13. See *id.* (noting that Ernst filed motion for summary judgment); see also *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986) (stating that court is required to deny motion for summary judgment if there is material issue of fact with respect to any element in plaintiff’s cause of action).

14. *Ikon*, 277 F.3d at 673 (discussing scienter requirements). For a further discussion of the *Ikon* court’s reasoning, see *infra* notes 125-50 and accompanying text.

have concluded . . . [the company's] financial statements were misstated and that as a result the public was likely to be misled."<sup>15</sup>

In the wake of the Andersen/Enron debacle, the Third Circuit's announcement of this standard does not indicate that the court is tightening the reigns on accounting firms, but rather, albeit justifiably, the court is relieving accountants from a market-perceived expectation of infallibility.<sup>16</sup> The Third Circuit recognizes that accountants only attest to the reliability of a company's financial statements; they provide no guarantees.<sup>17</sup> Because flawlessness is not expected, accountants must act intentionally before the Third Circuit deems them to have acted with scienter.<sup>18</sup> Consequently, the *Ikon* court's application of this standard reveals that potential plaintiffs may have to carry a difficult burden in order to prove an accounting firm's scienter in the absence of the proverbial smoking gun.<sup>19</sup>

This Casebrief reviews the Third Circuit's interpretation and application of Section 10(b)'s scienter requirement, while also looking at the *Ikon* holding's overall effect on the treatment of accounting firms in security fraud suits. First, Part II provides a general examination of Section 10(b) and Rule 10b-5's scienter requirement.<sup>20</sup> Part III analyzes the Third Circuit's approach to scienter, tracing the evolution of the scienter standard within this circuit.<sup>21</sup> Finally, Part IV discusses the broader implications of the scienter jurisprudence, namely, the effect of scienter on the Third Circuit's overall treatment of accounting firms' liability.<sup>22</sup> This final section will also provide advice to practitioners who may encounter a scienter issue.<sup>23</sup>

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15. *Ikon*, 277 F.3d at 673 (stating that because plaintiffs did not satisfy this demanding standard, there is no triable issue with respect to scienter and, thus, summary judgment in favor of Ernst & Young was granted).

16. *See id.* (noting that audits do not guarantee correct statements).

17. *See id.* (noting that professional audits only account for error).

18. *See id.* (discussing scienter requirements for accountants); *see also In re Ikon Office Solutions, Inc.*, 131 F. Supp. 2d 680, 702 (E.D. Pa. 2001) (noting that accounting is more like art than science, court states that "[t]he fact that a future prediction turns out to be wrong does not mean it was fraudulent").

19. *See Ikon*, 277 F.3d at 673 (noting that conduct must have been "sufficiently egregious").

20. For a further discussion of Section 10(b) and Rule 10b-5's scienter requirement, see *infra* notes 41-69 and accompanying text.

21. For a further discussion of the Third Circuit's treatment of scienter in cases prior to *Ikon*, see *infra* notes 70-103 and accompanying text.

22. For a further discussion of the broader implications of the Third Circuit's scienter jurisprudence, see *infra* notes 151-74 and accompanying text.

23. For a further discussion of advice to practitioners facing scienter issues, see *infra* notes 151-74 and accompanying text.

## II. SECTION 10(b) AND THE SCIENTER REQUIREMENT

A. *General Background of Section 10(b) and Rule 10b-5*

Passed in the aftermath of the 1929 stock market crash, the Exchange Act aimed to increase investor confidence in the public securities market by regulating the investments being offered and traded to prevent manipulation of stock prices.<sup>24</sup> Section 10(b) is the primary anti-fraud provision of the Exchange Act.<sup>25</sup> As a companion rule to Section 10(b), the SEC promulgated Rule 10b-5, which makes it illegal to defraud or deceive by any means or method in connection with the purchase or sale of any security.<sup>26</sup> Rule 10b-5 does not expressly grant private parties the right to bring an action.<sup>27</sup> Beginning in 1946, however, the United States District Court for the Eastern District of Pennsylvania recognized an implied right of action under the Rule in *Kardon v. National Gypsum Co.*<sup>28</sup> The Supreme Court has since put to rest any lingering questions regarding the legitimacy of private causes of action and their existence for violations of Rule 10b-5 is now well established.<sup>29</sup>

The federal courts are in general agreement regarding the basic elements required to state a valid cause of action under Section 10(b) and Rule 10b-5.<sup>30</sup> A plaintiff must show that the defendant (1) made a mis-

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24. See S. REP. NO. 792, at 1-5 (1934) (noting that 1934 Act also imposed regular reporting requirements on companies whose stock is traded on national securities exchanges).

25. See 15 U.S.C. § 78j (1994) (making deceptive conduct unlawful).

26. See David S. Escoffery, Note, *A Winning Approach to Loss Causation Under Rule 10b-5 in Light of the Private Securities Litigation Reform Act of 1995*, 68 FORDHAM L. REV. 1781, 1784 (2000) (describing history of Rule 10b-5); see also *Angelastro v. Prudential-Backe Sec., Inc.*, 764 F.2d 939, 942 (3d Cir. 1985) (recognizing that "in connection with" requirement of Section 10(b) actions requires causal connection between claimed fraud and purchase or sale of security).

27. See 17 C.F.R. § 240.10b-5 (1999) (stating specific behavior is "unlawful"); see also *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976) (reiterating that by its terms, Section 10(b) does not create express civil remedy for its violation and that neither Congress nor SEC suggested in adoption of Rule 10b-5 that private cause of action for violations existed).

28. 69 F. Supp. 512, 513 (E.D. Pa. 1946) (noting that plaintiffs sued defendant claiming that fraudulent misrepresentations and conspiracy caused plaintiffs to sell their stock to defendants for less than stock's true value).

29. See *Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10 (1971) (stating that plaintiff-investor was harmed financially because of defendant's fraud in sale of securities and thus plaintiff entitled to civil remedy pursuant to Section 10(b)); see also, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975) (supporting claim of private cause of action).

30. See, e.g., *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 212 (3d Cir. 2001) (stating that proof of these elements for securities fraud is "well settled"); *Gasner v. Bd. of Supervisors*, 103 F.3d 351, 356 (4th Cir. 1996) (describing plaintiff's burden of proof in Rule 10b-5 claim); *Shushany v. Allwaste, Inc.*, 92 F.2d 517, 520-21 (5th Cir. 1990) (noting five elements of securities fraud claim).

statement or an omission of a material fact,<sup>31</sup> (2) with scienter,<sup>32</sup> (3) in connection with the purchase or the sale of a security,<sup>33</sup> (4) upon which the plaintiff reasonably relied<sup>34</sup> and (5) the plaintiff's reliance was the proximate cause of the plaintiff's injury.<sup>35</sup>

A somewhat recent development in Section 10(b) litigation includes the Supreme Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver*.<sup>36</sup> There, the Court eliminated any private claim against professional advisers for aiding and abetting a securities fraud violation.<sup>37</sup> The plaintiff must show that a defendant actually engaged in manipulative or deceptive acts or made fraudulent representations.<sup>38</sup> The effect of this holding is that private plaintiffs must charge defendants as primary violators rather than secondary ones.<sup>39</sup> Nevertheless, *Central Bank* does not preclude a secondary actor, such as an accounting firm that prepares a fraudulent audit report, from facing liability under Section 10(b).<sup>40</sup>

#### A. History of the Scienter Requirement's Development

Section 10(b) of the 1934 Act makes it unlawful to use or employ "any manipulative or deceptive device or contrivance" in contravention of SEC

31. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (defining something as material under Rule 10b-5 actions when "there is a substantial likelihood that a reasonable shareholder would consider it important" in making investment decision).

32. See *Coleco Indus., Inc. v. Berman*, 567 F.2d 569, 574 (3d Cir. 1977) (noting elements of Section 10(b) action include scienter). For a further discussion of *Coleco*, see *infra* notes 70-72 and accompanying text.

33. See *Semerenco v. Cendant Corp.*, 223 F.3d 165, 181 (3d Cir. 2000) (noting that this element satisfies underlying purposes of Section 10(b) because it recognizes "causal effect that material misrepresentations, which raise the public's interest in particular securities, tend to have on the investment decisions of market participants who trade in those securities").

34. See *Basic*, 485 U.S. at 243-47 (discussing reliance requirement).

35. See *id.* at 242 (noting relationship between reliance and injury elements of Rule 10b-5); see also, e.g., *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 315 (3d Cir. 1997) (noting these elements).

36. 511 U.S. 164 (1994).

37. See *id.* at 191 (deciding that actors who do not commit manipulative or deceptive acts within meaning of Section 10(b) but who instead aid and abet violation are not liable under Section 10(b)).

38. See *id.* ("Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5 . . .").

39. See *Cramton*, *supra* note 3, at 169 (noting that federal courts of appeals are divided on whether primary liability reaches professional adviser (i.e., accountant) who stays in background approving fraudulent financial statement, but who does not make misrepresentation in person, or whose name is not included in document). For a further discussion of *Central Bank* and its relevance in *Ikon*, see *infra* note 119 and accompanying text.

40. See *Cent. Bank*, 511 U.S. at 191 ("The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability . . .").

rules.<sup>41</sup> Analyzing this language, the Court in *Ernst & Ernst v. Hochfelder*<sup>42</sup> held that a private cause of action does not exist under Section 10(b) and Rule 10b-5 in the absence of scienter, “a mental state embracing an intent to deceive, manipulate, or defraud.”<sup>43</sup> In finding the scienter requirement, the Court noted that “the words ‘manipulative or deceptive’ used in conjunction with ‘device or contrivance’ strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct.”<sup>44</sup> Because the Court in *Hochfelder* held that some element of scienter was necessary,<sup>45</sup> liability cannot be imposed for negligent conduct alone.<sup>46</sup>

The Court’s holding in *Hochfelder* clearly signals that the scienter requirement is satisfied where an accountant has an actual intent to defraud the plaintiff or where an accountant has actual knowledge that the accountant’s statements are materially false.<sup>47</sup> While the Supreme Court left open the question of whether allegations of “recklessness” satisfy the scienter requirement, the federal courts of appeals, beginning with the Seventh Circuit, have concluded that a defendant’s reckless action satisfies the scienter requirement.<sup>48</sup> Almost all circuits, including the Third Cir-

41. 15 U.S.C. § 78j(b) (1994).

42. 425 U.S. 185 (1976).

43. *Id.* at 193 n.12 (noting that accountants in *Hochfelder* had been retained by brokerage house to perform periodic audits and prepare annual reports; president of brokerage firm had defrauded many investors whose securities were held in nonexistent escrow accounts and thus investors sued accountants). The plaintiffs claimed that the accountants did not perform appropriate accounting procedures, which explained why the president’s fraud went undetected. *See id.* at 189-90 (describing plaintiffs’ theory of negligent nonfeasance).

44. *Id.* at 193 n.12 (noting that while recklessness is sometimes considered to be intentional conduct, Court chose not to address whether reckless behavior is sufficient for civil liability under Section 10(b) and Rule 10b-5).

45. *See id.* at 190 n.5 (concluding that accounting firm could not be held liable under Section 10(b) for conduct which plaintiff alleged to be “inexcusable negligence”).

46. *See id.* at 198-99 (emphasizing that in enacting 1934 Act Congress did not intend to bar all such practices, only those done knowingly or intentionally); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382-83 (1983) (noting that mere negligence is insufficient to satisfy scienter requirement); *see, e.g., McLean v. Alexander*, 599 F.2d 1190, 1198 (3d Cir. 1979) (“[N]egligence whether gross, grave or inexcusable cannot serve as substitute for scienter.”).

47. *See In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 571 (S. D. Tex. 2002) (stating that misstatement or omission of material fact must be made with scienter); *see also Hochfelder*, 425 U.S. at 193 n.12 (noting negligent conduct may suffice); *Maldonado v. Dominguez*, 137 F.3d 1, 9 (1st Cir. 1998) (defining scienter according to *Hochfelder*); *Lovelance v. Software Spectrum, Inc.*, 78 F.3d 1015, 1018 (5th Cir. 1996) (“In order to adequately plead scienter, a plaintiff must set forth specific facts to support an inference of fraud.”).

48. *See Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1046 (7th Cir. 1977) (rejecting defendant’s argument that he did not act with scienter because he lacked “actual knowledge of the danger” of misleading plaintiff). The court found scienter because the “objective obviousness of the danger” adequately justified liability “even absent an actual appreciation [by defendant] of the significance of the omitted material to [the plaintiff].” *Id.*

cuit,<sup>49</sup> have followed suit.<sup>50</sup> As the different circuits have defined “recklessness,” a variety of definitions have developed.<sup>51</sup> While all courts that have decided this issue agree that recklessness is something more than ordinary negligence, the precise standard varies.<sup>52</sup> Despite the wide range of definitions, the most widely accepted approach to “recklessness” is the Seventh Circuit’s definition:

Reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.<sup>53</sup>

Although the scienter requirement necessitates a showing of deliberate intent to mislead, the plaintiff is not required to prove that the defendant had a specific intent to defraud.<sup>54</sup> Accordingly, even where the

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49. See *Coleco Indus., Inc. v. Berman*, 567 F.2d 569, 574 (3d Cir. 1977) (finding for first time in Third Circuit that reckless conduct is actionable under Section 10(b)); see also *SEC v. Infinity Group Co.*, 212 F.3d 180, 193 (3d Cir. 2000) (discussing effect of good faith on scienter requirement); *Healey v. Catalyst Recovery of Pa.*, 616 F.2d 641, 649 (3d Cir. 1980) (adding to Third Circuit’s definition of recklessness); *McLean v. Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979) (attempting to define legal standard for recklessness by adopting Seventh Circuit’s standard verbatim). For a further discussion of the Third Circuit’s inclusion of recklessness within the definition of scienter, see *infra* notes 87-93 and accompanying text.

50. See *Alpern v. Utilicorp United, Inc.*, 84 F.3d 1525, 1534 (8th Cir. 1996) (including recklessness within definition of scienter while simultaneously accepting *Sundstrand’s* limited definition of scienter); *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259, 268-69 (2d Cir. 1993) (recognizing recklessness, but requiring “strong inference” of scienter as either facts establishing motive and opportunity to commit fraud or facts constituting circumstantial evidence of either reckless or conscious behavior); *SEC v. Steadman*, 967 F.2d 636, 641-42 (D.C. Cir. 1992) (allowing scienter to be proved through defendant’s reckless actions that showed extreme departure from standard of ordinary care and not merely heightened form or ordinary care); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1562, 1569 (9th Cir. 1990) (viewing recklessness as form of intentional or knowing misconduct, stating: “[r]ecklessness is a form of intent rather than a greater degree of negligence”) (citing *Vucinich v. Paine, Webber, Jackson & Curtis Inc.*, 739 F.2d 1434, 1435 (9th Cir. 1984)); *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809, 814-15 (11th Cir. 1989) (following “extreme departure from the standards of ordinary care” standard of recklessness) (quoting *Broad v. Rockwell Int’l Corp.*, 642 F.2d 929, 961-62 (5th Cir. 1981)).

51. For a further discussion of the other definitions adopted by various circuits, see *supra* note 44-52 and accompanying text.

52. For a further discussion of differences in definitions, see *supra* notes 44-50 and accompanying text.

53. *Sundstrand Corp.*, 553 F.2d at 1045; see also 7 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3525-30 (3d ed. 1991) (noting that *Sundstrand* definition has been characterized as “most widely followed approach” to defining recklessness for these purposes).

54. See, e.g., *United States v. Chiarella*, 588 F.2d 1358, 1370-71 (2d Cir. 1978), *rev’d on other grounds*, 445 U.S. 222 (1980) (stating that even in criminal case under



defendant is charged with "knowing misconduct," proof of intent to violate the law is not a prerequisite to establishing scienter.<sup>55</sup> Most cases that decide whether the scienter requirement was satisfied do so without inquiring into the defendant's perception of the materiality of the omitted or misrepresented facts,<sup>56</sup> whether the defendant understood (or was reckless in not recognizing) that the defendant's deception entailed a risk of misleading the investor in a material way.

Courts generally infer recklessness or fraud from circumstantial evidence.<sup>57</sup> Nevertheless, the circumstantial evidence must show more than mere negligence.<sup>58</sup> Thus, evidence such as expert testimony does not establish scienter because it only permits an inference that the actions of the accountant were negligent or unreasonable.<sup>59</sup> Another significant aspect of the federal courts' approach to scienter is that while the application of the Private Securities Litigation Reform Act of 1995 ("PSLRA")<sup>60</sup> has led

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securities laws, government must only prove that defendant intended to commit prohibited act).

55. See *SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 77 (D.C. Cir. 1980) (holding that determination of knowing misconduct does not require examination of defendant's subjective belief as to legality of his action). The *Falstaff* court stated:

Knowledge means awareness of the underlying facts, not the labels that the law places on those facts. Except in very rare instances, no area of the law—not even the criminal law—demands that a defendant have thought his actions were illegal. A knowledge of what one is doing and the consequences of those actions suffices. We therefore hold that because [defendant] knew the nature and consequences of his actions, he acted with scienter.

*Id.*

56. See Allan Horwich, *The Neglected Relationship of Materiality and Recklessness in Actions under Rule 10b-5*, 55 BUS. LAW. 1023, 1024 (2000) (mentioning that Third Circuit has suggested that "a defendant's 'appreciation of the consequences' of his conduct is part of the scienter analysis in an appropriate case"). But see *Pittsburgh Terminal Corp. v. Balt. & Ohio R.R. Co.*, 680 F.2d 933, 943 (3d Cir. 1982) (holding that scienter is established where defendants "know the materiality of the concealed information and intend the consequences of concealment"). For a further discussion of the Third Circuit's treatment of scienter, see *infra* notes 70-103.

57. See *Herman v. MacLean*, 459 U.S. 375, 390-91 n.30 (1983) (noting that circumstantial evidence can be "more than sufficient" to prove scienter in fraud cases); see also *Fine v. Am. Solar King Corp.*, 919 F.2d 290, 297-98 (5th Cir. 1990) (holding that jury could infer either recklessness or actual knowledge of fraud where accountants' own audit working papers indicated that they either were aware that provision for uncollectible accounts was insufficient or purposefully avoided in determining whether account was sufficient).

58. See *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1426 (9th Cir. 1994) (stating evidence of reasonable decisions "negates the plaintiffs' attempt to establish scienter").

59. See *id.* at 1425-27 (holding that auditor did not act with scienter; "self-righteous statements" or plaintiffs' expert were not sufficient to prove anything beyond negligence).

60. See Pub. L. No. 104-67, 109 Stat. 737 (codified as amended at 15 U.S.C. § 77z-1 (1995)); H.R. CONF. NO. 104-369, at 31, 41 (1995) (noting that PSLRA was enacted to reduce volume of non-meritorious federal securities lawsuits by erecting procedural barriers, namely, heightened pleading requirements for Rule 10b-5 claims); see also 15 U.S.C. § 78u-4(b)(2) (2003) (noting that pleading standards

to varying interpretations among the federal courts of appeals of what plaintiffs must plead in order to demonstrate scienter,<sup>61</sup> most courts have held that the PSLRA did not alter the scienter requirements under Section 10(b).<sup>62</sup>

Turning to the scienter requirement specifically in accountant liability cases (as opposed to the broad spectrum of all securities fraud cases under Section 10(b) and Rule 10b-5), the federal courts have also held that failure to follow Generally Accepted Accounting Principles<sup>63</sup> ("GAAP") and Generally Accepted Accounting Standards<sup>64</sup> ("GAAS")

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now include requirement that complaint "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind").

61. See, e.g., *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999) ("[A] private securities plaintiff proceeding under the PSLRA must plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct."); *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 550 (6th Cir. 1999) (holding that "plaintiff may survive a motion to dismiss by pleading facts that give rise to a 'strong inference' of recklessness"); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534-35 (3d Cir. 1999) (stating that plaintiff may establish requisite inference of fraudulent intent by alleging either "facts 'establishing a motive and an opportunity to commit fraud, or by setting forth facts that constitute circumstantial evidence of either reckless or conscious behavior'" (quoting *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 318 n.8 (3d Cir. 1997))); *Press v. Chem. Inv. Serv. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999) (holding that plaintiff can plead scienter by "either (a) alleg[ing] facts to show that 'defendants had both motive and opportunity to commit fraud' or (b) alleg[ing] facts that 'constitute strong circumstantial evidence of conscious misbehavior or recklessness'" (quoting *Shields v. Citytrust Bancorp., Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994))).

62. See *In re Comshare*, 183 F.3d at 550 ("The PSLRA did not disturb the well-settled understanding that 'scienter' is the requisite mental state for liability under § 10b or Rule 10b-5 cases."); *In re Advanta*, 180 F.3d at 534 (stating that PSLRA was only intended to modify procedural requirements of pleading, and that it left substantive law of securities fraud actions untouched); HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, *EMERGING TRENDS IN SECURITIES LAW* 7 (2001) (noting that Second and Third Circuit deemed PSLRA standard as remaining same as pre-PSLRA standard and that Sixth and Eleventh Circuits agree to some extent with Second and Third Circuits in that recklessness is appropriate basis for alleging and proving scienter). The Ninth Circuit's standard is the most demanding in that recklessness must reach the level of deliberate recklessness before scienter is proved and that motive and opportunity alone are not sufficient for drawing an inference of scienter. See *id.* (noting high standard to prove scienter in Ninth Circuit). The Sixth and Eleventh Circuits agree with the Ninth Circuit in that motive and opportunity alone are not a sufficient basis for pleading scienter. See *id.* (comparing reasoning of circuit courts).

63. See *SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1222-23 n.17 (S.D.N.Y. 1992) (explaining GAAP represents "basic postulates and broad principles of accounting pertaining to business enterprises, approved by the Financial Accounting Standards Board of the American Institute of Certified Public Accounts ('AICPA)'). These principles establish guidelines for measuring, recording, and classifying the transactions of a business entity").

64. See *id.* (noting GAAS are "standards prescribed by the Auditing Standards Board of the AICPA for the conduct of auditors in the performance of an examination"); see also *Vosgerichian v. Commodore Int'l*, 862 F. Supp. 1371, 1372 n.2 (E.D. Pa. 1994) ("GAAS and GAAP delineate due professional care owed by accountants to their clients as stated by the accounting community.").

alone does not establish scienter.<sup>65</sup> Nevertheless, compliance with GAAP “will not immunize an accountant if he consciously [chooses] not to disclose a known material fact.”<sup>66</sup> Essentially, there is no liability under Section 10(b) and Rule 10b-5 for ordinary professional malpractice.<sup>67</sup> An accountant’s error in judgment or failure to adequately investigate a matter is generally regarded as a negligence claim and is not actionable under Rule 10b-5.<sup>68</sup> But an inference of scienter may, however, be strengthened should the accountant have a motive to defraud.<sup>69</sup>

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65. See *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 430 n.12 (5th Cir. 2002) (explaining effect of GAAP on scienter determination). The *Abrams* court stated: [T]he mere publication of inaccurate accounting figures or failure to follow GAAP, without more, does not establish scienter; a plaintiff must show that the accounting firm deliberately misrepresented material facts or acted with reckless disregard about the accuracy of its audits or reports. The party must know that it is publishing materially false information, or must be severely reckless in publishing such information.

*Id.*; see also *United States v. Colasurdo*, 453 F.2d 585, 594 (2d Cir. 1971) (finding fundamental question is not compliance with GAAP but one of “honesty and good faith”); *United States v. Simon*, 425 F.2d 796, 805 (2d Cir. 1969) (affirming convictions of three accountants for securities and wire fraud even though accounting experts testified that accountants’ certification of client’s financial statements was in full compliance with GAAP). Technical compliance with GAAP is relevant but not conclusive evidence of the accountants’ good faith. See *id.* at 806. (“Such evidence may be highly persuasive, but is not conclusive . . .”); *Zucker v. Sasaki*, 963 F. Supp. 301, 307 (S.D.N.Y. 1997) (stating that general allegations of GAAP violations do not satisfy scienter requirement).

66. *SEC v. Seaboard Corp.*, 677 F.2d 1301, 1313 n.15 (9th Cir. 1982); *Contra id.* (stating that “accountant has no duty beyond compliance [with GAAP]”).

67. See *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 496 (7th Cir. 1986) (“[S]ecurities laws do not impose liability for ordinary malpractice.”).

68. See *Wells v. Monarch Capital Corp.*, No. 97-1221, 1997 U.S. App. LEXIS 30031, at \*21 (1st Cir. Oct. 29, 1997) (concluding that while accountants involved in case may have made mistake, such mistakes do not support finding of scienter); *Beissinger v. Rockwood Computer Corp.*, 529 F. Supp. 770, 783 (E.D. Pa. 1981) (noting that use of particular language was no more than error in judgment not rising beyond level of negligence); cf. *Simon*, 425 F.2d at 806-07 (discussing accountant’s duty when accountant detects impropriety). The *Simon* court stated that general accounting principles:

[I]nstruct an accountant what to do in the usual case where he has no reason to doubt that the affairs of the corporation are being honestly conducted. Once he has reason to believe that this basic assumption is false, an entirely different situation confronts him. Then . . . he must “extend his procedures to determine whether or not such suspicions are justified.” If as a result [of further inquiry] he finds his suspicions to be confirmed, full disclosure must be the rule, unless he has made sure the wrong has been righted and procedures to avoid a repetition have been established.

*Id.*

69. Cf. *Barker*, 797 F.2d at 497 (stating that “the court should ask whether the fraud (or cover-up) was in the interest of the [accountants]”).

### III. THE THIRD CIRCUIT'S APPROACH TO THE SCIENTER REQUIREMENT

#### A. *Third Circuit Precedent Prior to In re Ikon Office Solutions, Inc.*

Following the Supreme Court's decision in *Hochfelder*, the Third Circuit in *Coleco Industries, Inc. v. Berman*,<sup>70</sup> like many other circuits, held that reckless conduct is actionable under Section 10(b) and Rule 10b-5's scienter requirement.<sup>71</sup> Nevertheless, the debate regarding scienter was not over as the court in *Coleco* chose not to define the precise level of recklessness that it will allow to show scienter.<sup>72</sup> In *McLean v. Alexander*,<sup>73</sup> the court attempted to define the legal standard for recklessness, but *McLean* did not solve all of the problems concerning scienter.<sup>74</sup>

*McLean* is an accountant liability case in which the plaintiff alleged that Cashman & Schiavi ("C&S"), a firm of certified public accountants, recklessly represented in an audited balance sheet that the corporation at issue had legitimate sales when in fact the underlying transactions were merely consignments.<sup>75</sup> Because the accountants claimed that they acted in good faith, the court had to determine the necessary degree of culpabil-

70. 567 F.2d 569, 571-73 (3d Cir. 1977) (noting case dealt with Coleco Corporation's acquisition of Royal Corporation and Coleco's claim that figures on Coleco's balance sheet were misstated, leading to Rule 10b-5 violation). The Royal defendants contended that the figures were made in good faith. *See id.* at 572 (arguing defendants were misled by errors of accountant). The court held that there was no violation of Rule 10b-5 because plaintiffs failed to prove scienter. *See id.* at 579 (explaining plaintiffs had no valid claim because plaintiffs could not prove defendants' misrepresentations were recklessly made or made with fraudulent intent).

71. *See id.* at 574 (stating that scienter element in Section 10(b) case required "a conscious deception or . . . a misrepresentation so recklessly made that the culpability attaching to such reckless conduct closely approaches that which attaches to conscious deception") (citing *Coleco Indus., Inc. v. Berman*, 423 F. Supp. 275, 296 (E.D. Pa. 1976)).

72. *See id.* (noting that Third Circuit in *Coleco* chose not to "precisely define" legal standard for recklessness).

73. 599 F.2d 1190 (3d Cir. 1979).

74. *See id.* at 1197-98 (noting that court adopted Seventh Circuit's standard for determining liability under Section 10(b) in court's attempt to "precisely define the legal standard for recklessness").

75. *See id.* at 1196 (noting that plaintiff, McLean, engaged in large stock purchase of Technidyne stock, relying on audited balance sheet prepared by C&S, which included false representations of Technidyne's past sales and future sales potential). Once McLean realized that he had been defrauded, he and others sued C&S. *See id.* at 1194 (stressing McLean's reliance on sales figures as factor in his purchase of Technidyne stock). The trial court found that the only figure on the balance sheet that was false or misleading was the accounts receivable figure. *See id.* at 1195 (explaining that McLean viewed accounts receivable figure as representing almost entirely accounts due and owing as result of sixteen recent sales); *see also* SCOTT A. TAUB, 2003 MILLER GAAP GUIDE SPECIAL SUPPLEMENT: REVENUE RECOGNITION § 5.13-5.14 (2003) (explaining that for accounting purposes, shipment of goods on consignment does not constitute sale, and thus there should be no recognition of income). In general, "[a] shipment of goods 'on consignment' generally indicates that payment is expected only upon resale or use of the product by the purchaser and that unsold items may be returned to the seller . . . title

ity to implicate Rule 10b-5 liability.<sup>76</sup> The court held that C&S did not have the requisite level of scienter under Section 10(b).<sup>77</sup> Specifically, the court stated:

There was no evidence that Schiavi, the C&S partner in charge of the audit, had actual knowledge of the consignment arrangements, or even that he was aware of the risk that they were consignment sales. Thus, C&S could be held to have the requisite scienter only if the investigation it made, and the knowledge it had, gave rise to an inference that "it must have been aware" of the risk that the accounts receivable item was misleading.<sup>78</sup>

In making this determination, the Third Circuit adopted the Seventh Circuit's test for recklessness, reiterating that liability under Section 10(b) requires "an extreme departure from the standards of ordinary care."<sup>79</sup> The court in *McLean* further stated that to demonstrate scienter "the plaintiff [must] establish that the defendant lacked a genuine belief that the information disclosed was accurate and complete in all material respects."<sup>80</sup> This standard emphasizes that some sort of knowledge or awareness is required before the Third Circuit will find scienter. One reason the Third Circuit decided to adopt the Seventh Circuit standard of recklessness was because it preserves the standards of scienter in the context of accountant liability that were developed by Judge Cardozo in *Ultramares*

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generally does not pass until the purchaser resells the inventory to its customer." *Id.*

76. *See McLean*, 599 F.2d at 1196 (stating issue of case as "whether the accountant proceeded in a deliberate, knowing or reckless manner in the preparation of his audit").

77. *See id.* at 1199 (stating that there were inconsistencies in Technidyne's documentation that should have put C&S on notice that items Technidyne claimed as sales were only consignments). The court stated: "[i]f we were applying a negligence standard we could affirm a finding that . . . [C&S] should have made further inquiry of management . . . before concluding that the accounts receivable was genuine." *Id.* at 1199-1200. Nevertheless, the court noted that this neglect does not alone suggest that C&S was aware that it was without sufficient knowledge to form its audit opinion. *See id.* at 1200 (requiring more than neglect to prove scienter). To so hold "would obliterate the distinction between tortious conduct requiring scienter . . . and negligence." *Id.*

78. *Id.* at 1199 (stating that C&S did not act recklessly). The court noted, "[t]he accountant examined purchase orders and invoices which appeared genuine, received representations from management, took steps to obtain confirmation from the account debtors, and received partial confirmation of 15 of the 16 sales centrally in issue." *Id.* at 1202.

79. *Id.* at 1197 (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977)). The court noted that even though the Seventh Circuit only applied this standard to omissions, the Third Circuit thought that it also applied to misstatements. *See id.* (looking at reasoning of Seventh Circuit). For a further discussion of the *Sundstrand* test, see *supra* notes 48-53 and accompanying text.

80. *McLean*, 599 F.2d at 1198 (noting further, in strong language, that "negligence whether gross, grave or inexcusable cannot serve as substitute for scienter").

*Corp. v. Touche*,<sup>81</sup> namely, that an accountant is guilty of fraud upon “a showing that a misrepresentation was made knowingly or willfully, or with reckless disregard for its truth or falsity, or without a ‘genuine belief’ in its truth.”<sup>82</sup> This deference demonstrates the Third Circuit’s continued requirement of proof that accountants act intentionally before the court will find scienter, a very high level of recklessness.<sup>83</sup> Accordingly, *McLean* demonstrates that a finding of negligence, no matter how gross, will never satisfy the Third Circuit’s scienter requirement.<sup>84</sup>

The *McLean* court’s strong language sets the Third Circuit’s strict tone, suggesting that plaintiffs will have to make a strong showing in order to prove scienter.<sup>85</sup> Nevertheless, the court stated that circumstantial evidence showing essentially a reckless disregard for the truth may adequately prove scienter:

To prove scienter the plaintiff need not produce direct evidence of the defendant’s state of mind. Circumstantial evidence may often be the principal, if not the only, means of proving bad

81. 255 N.Y. 170, 174 (1931) (noting that defendants, public accountants, were hired to prepare and certify balance sheet and although accountants certified various accounts as accurate, accounts had, in fact, been wiped out and business was insolvent). The court found that if defendants had made statements as true without knowledge on the subject, they could be liable for fraud. *See id.* (explaining that verification is essential function of accountant); *see also McLean*, 599 F.2d at 1198 (quoting *O’Connor v. Ludlam*, 92 F.2d 50, 54 (2d Cir. 1937)). The court in *McLean* also references another application of the early common law scienter requirement in deciding whether accountants are guilty of fraud:

[The] issue [is] whether the defendants had an honest belief that the statements made by them were true. If they did have that honest belief, whether reasonably or unreasonably, they are not liable. If they did not have an honest belief in the truth of their statements, then they are liable, so far as [scienter] is concerned.

*O’Connor*, 92 F.2d at 54.

82. *McLean*, 599 F.2d at 1198 (citing *Ultramares*, 255 N.Y. at 179-89); *see also id.* at 1200 (failing to make further inquiry even in light of circumstances that suggest further inquiry is necessary (i.e., discrepancies between due dates on inventories) does not rise beyond level of negligence because this does not indicate that “C&S knew that it lacked the knowledge required to form an opinion” regarding Technidyne’s sales).

83. *See id.* at 1198 (reiterating that “negligence whether gross, grave or inexcusable cannot serve as substitute for scienter”).

84. *See id.* at 1198 (stating that purpose of *Hochfelder*’s footnote 12 (where court did not decide question of whether recklessness satisfies Rule 10b-5 scienter’s requirement) was to preserve “the standards of scienter developed in *Ultramares*”); *see also Ultramares*, 255 N.Y. at 179 (“If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class.”).

85. *See McLean*, 599 F.2d at 1199 (noting Third Circuit’s tough rhetoric when it stated that “C&S could be held to have the necessary scienter *only* if the evidence supports an inference that when it expressed the opinion it had *no* genuine belief that it had the information on which it could predicate that opinion”) (emphasis added).

faith. A showing of shoddy accounting practices amounting at best to a "pretended audit," or of grounds supporting a representation "so flimsy as to lead to the conclusion that there was no genuine belief back of it" have traditionally supported a finding of liability in the face of repeated assertions of good faith . . . .<sup>86</sup>

The Third Circuit further clarified its position regarding scienter in *Healey v. Catalyst Recovery of Pennsylvania, Inc.*<sup>87</sup> There, the court stated that the level of recklessness that will satisfy the Section 10(b) scienter requirement is closer to intentional conduct rather than any "indifference to the consequences."<sup>88</sup> This emphasizes the stringent definition of recklessness that the Third Circuit accepts.<sup>89</sup> The Third Circuit further defined its position regarding recklessness, specifically in accountant liability contexts.<sup>90</sup> The court stated that "mistakes in accounting calculations, unreasonable accounting procedures, or even outright violations of professional standards, without more, simply do not establish scienter."<sup>91</sup> Moreover, malpractice alone does not amount to fraud.<sup>92</sup> Regarding an attempt to find scienter from an expressed opinion, the Third Circuit

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86. *Id.* at 1198 (citing *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977)) (demonstrating difficulty in proving scienter, court stated that "the inquiries of management, the awareness of [past practices], and the partial telegraphic confirmation simply cannot be characterized as 'grounds . . . so flimsy as to lead to the conclusion that there was no genuine belief back of [C&S's] representation to that effect'").

87. 616 F.2d 641, 649 (3d Cir. 1980) (noting that minority shareholder sued on grounds that he was denied material information that precluded him from enjoining merger; by analyzing elements of cause of action under Rule 10b-5, court held that plaintiff's claim constituted cause of action under Rule 10b-5). The court held that there was sufficient evidence to create a jury question as to the defendants' scienter because the defendants *knew* the plaintiff's requests for allegedly material information had not been complied with. *See id.* at 650 (noting evidence on scienter under relevant standard).

88. *Id.* (rejecting jury instructions defining recklessness under Rule 10b-5 as one done with "indifference to the consequences"). The court also stated that "*Sundstrand* was a proper reading of *Ernst & Ernst* because it defined recklessness as being relatively close to intentional conduct." *Id.*

89. *See In re Ikon Office Solutions, Inc. Sec. Litig.*, 131 F. Supp. 2d 680, 692 (E.D. Pa. 2001) (referring to rhetoric in *Healey*).

90. *See id.* (exploring duties of accountant).

91. *Id.* (citing *In re Worlds of Wonder*, 35 F.3d 1407, 1426 (9th Cir. 1994)); *see also In re Bell Atl. Corp. Sec. Litig.*, No. CIV.A. 91-0514, 1997 U.S. Dist. LEXIS 4938, at \*114 (E.D. Pa. Apr. 17, 1997) ("The mere publication of inaccurate accounting figures, or a failure to follow GAAP without more, does not establish scienter.").

92. *See id.* (citing *Quest Med. Group, Inc. v. Kirschner Med. Corp.*, No. CIV.A. 90-858, 1992 U.S. Dist. LEXIS 14597, \*13 (D. Md. July 29, 1992)) ("If an accounting firm could be charged with fraud every time that its audit did not conform to [GAAP], then every claim of malpractice would also constitute a claim of fraud.") (quoting *E. F. Hutton Mortgage Corp., v. Pappas*, 690 F. Supp. 1465, 1471 (D. Md. 1988)).

stated that demonstrating after the fact that an opinion turned out to be incorrect does not give rise to scienter.<sup>93</sup>

In *SEC v. Infinity Group Co.*,<sup>94</sup> the Third Circuit further examined the effect of good faith on the Section 10(b) scienter requirement.<sup>95</sup> In this case, investors in the Infinity Group Company Trust ("TIGC") charged that the creators of the trust ran an ongoing scheme to defraud public investors through the offer and sale of TIGC securities.<sup>96</sup> The defendants claimed that because "they sincerely believed in the investments that TIGC made," the SEC failed to establish the scienter requirement of Section 10(b).<sup>97</sup> The Third Circuit explained that one may still be guilty of a Section 10(b) violation even though one has a good faith belief that one made true representations.<sup>98</sup> In other words, "[a] good faith belief is not a 'get out of jail free card.' It will not insulate the defendants from liability if it is the result of reckless conduct."<sup>99</sup>

The court noted that the evidence in *Infinity Group* made the defendants' guilt fairly obvious, despite claims that they always acted in good

93. See *Eisenberg v. Gagnon*, 766 F.2d 770, 776 (3d Cir. 1985) (discussing issues of retrospection). The *Eisenberg* court noted:

In establishing scienter with respect to projections and opinions, it is insufficient to show mere negligent conduct or that a forecast turned out to be inaccurate. However, . . . an opinion must not be made with reckless disregard for its truth or falsity, or with a lack of a genuine belief that the information disclosed was accurate and complete in all material respects. Therefore, an opinion that has been issued without a genuine belief or reasonable basis is an 'untrue' statement which, if made knowingly or recklessly, is culpable conduct actionable under § 10(b) of the Securities Exchange Act of 1934, Rule 10b-5.

*Id.*; see also *Kline v. First W. Gov't Sec.*, 24 F.3d 480, 486 (3d Cir. 1994) (noting that opinion that is decidedly untrue and issued recklessly could be susceptible to liability under Section 10(b)).

94. 212 F.3d 180 (3d Cir. 2000).

95. See *id.* at 192 (holding that good faith "does not necessarily preclude a finding of recklessness").

96. See *id.* at 185 (noting that operators of TIGC invested less than half of money solicited from public investors and failed to disclose to investors mounting losses; instead operators used at least \$3.5 million of approximately \$26.6 million invested for their personal home, new Mercedes Benz, household expenses, son's education, jewelry and bowling equipment). Because of the securities fraud, the plaintiffs succeeded in persuading the lower court to grant a permanent injunction enjoining defendants from further violations of securities laws. See *id.* at 186 (summarizing lower court's ruling).

97. *Id.* at 192 (noting that on appeal SEC maintained that TIGC's scienter was evidenced by TIGC's guarantees of high rates of return that were unsupported by any honest due diligence).

98. See *id.* at 192 (noting that "even if the defendants believed TIGC's investments were sound, they may still be liable for securities fraud if their belief was based upon nothing more than a reckless disregard of the truth").

99. *Id.* at 193 (reiterating that good faith belief may still accompany finding of recklessness and that "ignorance provides no defense to recklessness where a reasonable investigation would have revealed the truth to the defendant").



faith.<sup>100</sup> Alluding to *McLean*, the court stated that if an opinion is based on materials when the “circumstances suggest that they cannot be relied on without further inquiry, then the failure to investigate further may ‘support[ ] an inference that when [the defendant] expressed the opinion it had no genuine belief that it had the information on which it could predicate that opinion.’”<sup>101</sup> Translated into the accounting context, the court’s words suggest that when an accounting firm turns a blind eye to materials whose veracity is questionable, it may nevertheless predicate a finding of scienter.<sup>102</sup>

This evolution of the scienter requirement, beginning with *Coleco* in 1977 to *Infinity Group* in 2000, set the tone for the Third Circuit’s rather demanding scienter standard, establishing that even gross negligence will not give rise to scienter.<sup>103</sup> By 2002, the Third Circuit was prepared to further define the Section 10(b) scienter requirement.

#### B. In re Ikon Office Solutions, Inc.

##### 1. Facts and Procedural History

Ernst was retained as Ikon’s auditor for fiscal year 1997; the accuracy of Ernst’s audit opinion for that year was the central issue in the case.<sup>104</sup> On October 15, 1997, Ikon issued a press release reporting fourth-quarter and year-end results.<sup>105</sup> Most significantly, Ikon noted a fifteen percent rise over fiscal 1996 in income from continuing operations.<sup>106</sup> Then, on December 24, 1997, Ernst issued its unqualified audit opinion,<sup>107</sup> stating that Ikon’s 1997 financial statements fairly reflected its financial position.<sup>108</sup>

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100. See *id.* at 194-95 (noting that defendants did not take steps to ensure that their investments were legitimate, such as obtaining certified financial statements from programs in which it invested, determining whether programs were insured, obtaining legal opinions and certificates of good standing).

101. *Id.* at 194 (quoting *McLean v. Alexander*, 599 F.2d 1190, 1198 (3d Cir. 1979)).

102. For a further discussion of the meaning of scienter in the accounting context, see *supra* notes 63-69 and accompanying text.

103. See *Healey v. Catalyst Recovery of Pa., Inc.*, 616 F.2d 641, 649 (3d Cir. 1980) (noting that scienter is similar to intentional conduct).

104. See *In re Ikon Office Solutions, Inc. Sec. Litig.*, 277 F.3d 658, 663 (3d Cir. 2002) (noting that Ernst had served as Ikon’s independent outside auditor for number of years prior to 1997). The fiscal year ended on September 30. See *id.* at 662-63 (defining applicable fiscal year).

105. See *id.* (stating that Ernst reviewed press release before it was issued but did not propose any modifications).

106. See *id.* (reporting income from continuing operations totaling \$204.9 million for fiscal 1997).

107. See *id.* at 664 n.4 (explaining that unqualified audit opinion is “the highest level of assurance that an auditor can give on an organization’s financial statements . . . [a]ccountants will ‘qualify’ their opinion where discrepancies are identified in a client’s financial statements”).

108. See *id.* (following issuance of Ernst’s unqualified audit opinion, share values of Ikon common stock increased in value).

Nevertheless, on April 22, 1998, Ikon announced that its second quarter earnings for fiscal year 1998 would not meet published estimates and that third and fourth quarter earnings would likely fall below expectations.<sup>109</sup> In response to this report, Ikon's stock experienced a one-day decline of 27.08 percent—dropping from \$34.625 to \$25.250 by closing.<sup>110</sup> As more reports stating that Ikon would not meet its earnings estimates were made public, the stock continued to decline; by June 29, 1998, the shares of Ikon common stock closed at \$15.31.<sup>111</sup>

In response, Ikon hired Ernst to review all the significant account balances on certain Ikon units, a project known as the "Special Procedures."<sup>112</sup> To review Ernst's work on the Special Procedures and Ernst's work on the 1997 audit, Ikon also hired Andersen.<sup>113</sup> Following the conclusion of the Special Procedures, Ikon announced a \$110 million downward adjustment to earnings which included a \$94 million reduction in pre-tax charges applied to its 1998 third quarter earnings and a restatement of its previously reported and unaudited 1998 second quarter earnings to reflect \$16 million in pre-tax charges.<sup>114</sup>

Plaintiffs-appellants were representatives of a certified class consisting of all persons who purchased common stock, convertible preferred stock or call options of Ikon between the October press release announcing year-end results and the announcement of the Special Procedures restatements.<sup>115</sup> They brought this action initially against Ikon and certain individual defendants related to it.<sup>116</sup> Soon thereafter appellants amended their complaint, adding Ernst as a defendant.<sup>117</sup> The complaint alleged that the 1997 financial statements overstated pre-tax income and that, under Section 10(b) and Rule 10b-5, Ernst knew or must have been aware of these overstatements when it issued its unqualified audit opinion with

109. *See id.* at 664 (noting that although Ikon cited many reasons for lowered earnings, Ikon did not mention accounting charges to rectify discrepancies in its 1997 financial statements).

110. *See id.* (explaining drastic market reaction following issuance of report).

111. *See id.* (stating that by mid-August Ikon was trading at \$9.31 per share).

112. *See id.* (noting that project involved reviewing books of each of Ikon's North American and United Kingdom business services).

113. *See id.* (permitting Andersen to review all work papers from Ernst's 1997 audit, Ikon's first and second limited 1998 quarterly reviews and Special Procedures).

114. *See id.* at 684-85 (noting that \$110 million in charges specifically included \$28 million to cover defaults on leases, \$20 million for unpaid accounts receivable, \$35 million for adjustments due to internal controls failures at four operating units, \$20 million due to asset impairment and \$7 million in miscellaneous adjustments).

115. *See id.* at 662 (defining class of plaintiffs).

116. *See id.* (outlining claim).

117. *See id.* at 665 (stating that in November 1999 Ikon defendants settled with plaintiff class for \$111 million).

respect to those statements.<sup>118</sup> The plaintiffs also claimed that Ernst was reckless in failing to discover deficiencies in Ikon's financial statements in connection with Ikon's October 15, 1997 press release.<sup>119</sup>

The Ikon defendants settled with the plaintiff class for \$111 million.<sup>120</sup> As the only remaining defendant, Ernst filed a motion for summary judgment.<sup>121</sup> The district court entered judgment in Ernst's favor, stating that plaintiffs failed to adduce sufficient evidence to show a loss due to the allegedly fraudulent misstatements and, as particularly noteworthy here, that plaintiffs failed to make the requisite showing of scienter.<sup>122</sup> The shareholders appealed the district court's decision.<sup>123</sup> The Third Circuit affirmed, concluding that Ernst did not recklessly or knowingly issue a materially false and misleading audit opinion after reviewing Ikon's 1997 year-end financial statements.<sup>124</sup>

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118. *See id.* (alluding that Ernst harbored intent to deceive or acted with reckless disregard for accuracy of Ikon's financial disclosures). This complaint also brought up the issue of causation; namely, whether Ikon's corrective accounting disclosures caused Ikon's stock price to drop. *See id.* at 662 (outlining allegation against Ernst).

119. *See id.* at 668 n.8 (noting that issue turns on interpretation of *Central Bank's* repudiation of aiding-and-abetting liability under Section 10(b)). The Third Circuit reiterated the district court's decision that because Ikon's press release neither mentioned Ernst by name nor attributed any representations to Ernst, to hold Ernst liable for representations in a press release would be contrary to *Central Bank*. *See id.* at 667-68 (referencing precedent in finding that Ernst cannot be liable for contents of press release). Essentially, Ernst "at best facilitated the principal actor's disclosures, and therefore, did not 'make' a material misstatement." *Id.* Although seeming to agree with the district court, the Third Circuit chose not to address this issue because doing so would involve determining whether the "substantial participation" test adopted by other courts violates *Central Bank*. *See id.* (explaining Third Circuit's avoidance of "material misstatement" issue).

120. *See id.* at 665 (describing procedural history).

121. *See* FED. R. CIV. P. 56(c) (stating that summary judgment shall be granted if pleadings, depositions, answers to interrogatories, admissions on file and any affidavits show that there is no genuine issue as to any material fact and that moving party is entitled to judgment as matter of law); *see also* *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 249 (1986) (concluding that at summary judgment stage court does not weigh evidence for veracity, but determines whether or not there is genuine issue for trial).

122. *See Ikon*, 277 F.3d at 668 (noting that district court also entered partial summary judgment in Ernst's favor for period between October 15 press release and Ernst's announcement of its audit opinion, in which plaintiff class based its theory of liability on Ikon's press release).

123. *See id.* at 661-62 (specifying stage of litigation).

124. *See id.* (noting that because appellants failed to show scienter, their Section 10(b) claim failed and court did not have to reach issue of causation).

2. *Defining the Contours of the Scierter Requirement in Accountant Liability Litigation*

In affirming the district court on scierter grounds, the Third Circuit essentially established an “egregious accountant” standard.<sup>125</sup> The court did not go as far as developing an entirely new standard under which to determine accountant liability so much as it synthesized the Third Circuit’s prior decisions into one standard.<sup>126</sup> The court stated:

To give rise to section 10(b) liability for fraud, . . . appellants must show that Ernst’s judgment—at the moment exercised—was sufficiently egregious such that a reasonable accountant reviewing the facts and figures should have concluded that IKON’s financial statements were misstated and that as a result the public was likely to be misled.<sup>127</sup>

This emphasis on viewing an accountant’s conduct “at the moment exercised” demonstrates that the Third Circuit seeks to avoid holding the accountant to a higher standard merely because, in hindsight, the accountant’s conduct appears more egregious.<sup>128</sup> Because much of the litigation against accounting firms results because shareholders need to find a deep pocket after the fact, this stance is particularly advantageous for the accounting profession.<sup>129</sup> By eliminating hindsight from the scierter equation, accountants are less likely to be found in violation of securities laws.<sup>130</sup>

This standard also involves asking whether a similarly situated accountant would have reached the same results as the accountant in question.<sup>131</sup> The court gave considerable deference to the fact that Andersen, a reasonable accountant, and even a market rival, did review the financials

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125. *See id.* (“[A]ppellants must show that Ernst’s judgment—at the moment exercised—was sufficiently egregious”).

126. *See id.* at 673 (stating standard).

127. *Id.* at 673.

128. *See id.* (citing *Denny v. Barkber*, 576 F.2d 465, 470 (2d Cir. 1978)). The Second Circuit rejected “fraud by hindsight” because the law does not demand clairvoyance. *See id.* (rejecting fraud claims beyond those where scierter is found at time of act in question). The Second Circuit stated: “[t]he claim that appellants’ experts, in retrospect, would have compared assets against balance sheets on a monthly basis . . . does not illustrate that Ernst’s incongruous auditing tactics were unjustified, let alone reflected an intent to defraud or rash disregard for the likelihood of deception.” *Id.* at 676; *see also McLean v. Alexander*, 599 F.2d 1190, 1199 (3d Cir. 1979) (emphasizing that scierter could only be found if at moment accounting firm “expressed the opinion” it did not believe in truth of its expression, indicating Third Circuit’s similar distrust of hindsight as factor in accountant liability cases).

129. *See Ikon*, 277 F.3d at 673 (forming Third Circuit standard to which accountants must conform).

130. *See id.* (same).

131. *Id.* (finding standard must be viewed in light of “a reasonable accountant”).

and “found nothing that ‘would be a significant issue’ regarding the quality of Ernst’s opinion.”<sup>132</sup> Nevertheless, the court established that Andersen’s similar finding did not completely shield Ernst from liability.<sup>133</sup>

From there, the court recognized the fact-specific nature of determining scienter (or in this case, of determining whether a genuine issue of material fact regarding scienter existed) and launched into an accurate and probing analysis of the specific allegations raised by the appellants.<sup>134</sup> Among other arguments, the appellants claimed that Ernst deliberately disregarded a warning from an Ikon officer that Ikon employees were being forced to deceptively boost income.<sup>135</sup> The court dismissed this claim because it felt that Ernst responded appropriately to this allegation by notifying Ikon management of the claim and by encouraging Ikon to hire independent counsel to investigate.<sup>136</sup> The court reasoned, “[t]he mere fact that Ernst did not conduct its own fraud investigation or alert its field auditors to the allegations of fraud is not probative, as the relevant inquiry is bad faith, not judgment.”<sup>137</sup> Thus, in the Third Circuit, evidence of a failure to investigate a red flag is insufficient to support the scienter requirement, especially where the accountant has otherwise acted reasonably.<sup>138</sup>

The appellants also claimed that a checklist made during the planning stage of the 1997 audit where Ernst noted risk factors resulting from Ikon management’s preference for favorable earnings raised an inference of scienter sufficient to survive this summary judgment motion.<sup>139</sup> The court dismissed this claim in quick fashion, stating that if the scienter re-

132. *See id.* at 669 (noting that various Andersen partners declared that Ernst did not appear to have done anything wrong).

133. *See id.* (“Andersen’s conclusions do not provide cover categorically to insulate Ernst from liability . . .”).

134. *See In Re Ikon Office Solutions, Inc. Sec. Litig.*, 131 F.Supp. 2d 680, 692 (E.D. Pa. 2001) (noting that scienter is so fact-specific that it is often left to trier of fact to decide).

135. *See Ikon*, 277 F.3d at 670 (noting that court also dismissed allegations that Ikon’s CFO had been “cooking the books”).

136. *See id.* (noting that this evidence, which addresses concerns raised late in 1998, is not at all connected to any manipulations that could have occurred in Ernst’s preparation of its 1997 audit opinion, and thus suggests Ernst did not depart from standards of ordinary care).

137. *Id.* (concluding that this allegation did not raise material dispute of fact on which to base finding of scienter).

138. *See id.* at 676 (noting that even where Ernst possibly erred in eliminating intercompany earnings from pre-tax earnings, “an inference of recklessness . . . that otherwise might be drawn cannot survive the fact that Ernst thoroughly reviewed and tested Ikon’s intercompany balances”).

139. *See id.* at 671 (delineating where Ernst checked “yes” for presence of risk factors, such as “unduly aggressive earnings targets” and “excessive interest in maintaining or increasing Ikon’s stock price”). The appellants contend that this checklist demonstrates that Ernst knew about the pressure Ikon put on its employees to take drastic measures to reach profit goals and stock price maximization. *See id.* (summarizing appellants’ allegations).

quirement could be satisfied by arguing that a company defrauded the public because an inflated stock price would increase its compensation, then “virtually every company in the United States that experiences a downturn in stock would be forced to defend securities fraud actions.”<sup>140</sup> Moreover, this was merely a checklist created in the early stages of the audit, which if anything “tends to corroborate Ernst’s diligence in conducting the 1997 audit.”<sup>141</sup>

Additionally, the Third Circuit did not appreciate the appellants’ efforts in picking apart the 1997 audit in order to find scienter.<sup>142</sup> The court stated that a fishing expedition for isolated errors in a post-audit hunt does not alone support a finding of intentional deceit or of recklessness.<sup>143</sup> Put simply, the “mere second-guessing of calculations will not suffice.”<sup>144</sup> Auditors are only expected to express an opinion on the fairness with which management presents its financial position—auditors are not guarantors of anything.<sup>145</sup> Expectations of “flawless levels of professional care and judgment” are groundless.<sup>146</sup> Rather, to demonstrate Section 10(b) liability for fraud, the appellants would need to prove that “Ernst harbored an intent to deceive or exhibited a reckless disregard for the likelihood of fraud by exercising divergent, but nevertheless principled, methodologies in auditing Ikon’s financial statements.”<sup>147</sup>

Likewise, the appellants claimed that Ernst had actual knowledge of \$20.8 million in understatements in Ikon’s financial statements when it issued its audit opinion; the court stated this claim was unfounded.<sup>148</sup> The court explained that the appellants derived the \$20.8 million figure from their own vision as to how the audit should have been conducted,

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140. *Id.* (quoting *Acito v. IMECERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995)) (foreseeing consequences if scienter requirement could be met so easily).

141. *Id.* (referencing auditor’s duty to determine whether management is trying to defraud public by misstating financial statements); *see also* *P. Schoenfeld Asset Mgmt., LLC v. Cendant Corp.*, 142 F. Supp. 2d 589, 607 (D.N.J. 2001) (same).

142. *See Ikon*, 277 F.3d at 672 (rejecting appellants’ contention that deficiencies in Ikon’s internal controls, of which Ernst was aware, support inference of recklessness sufficient to support finding of scienter).

143. *See id.* at 673 (emphasizing that hindsight does not support finding of scienter).

144. *Id.* (anticipating that reasonable accountants may have different findings regarding accuracy of financial statements).

145. *See id.* (“An audit does not guarantee that a client’s accounts and financial statements are correct any more than a sanguine medical diagnosis guarantees well-being.”).

146. *La Rosa v. Scientific Design Co.*, 402 F.2d 937, 943 (3d Cir. 1968); *see also Ikon*, 277 F.3d at 673 (stating that even perfectly conducted audit “countenances some degree of calibration for tolerable error, which on occasion, may result in a failure to detect a material omission or misstatement”).

147. *Ikon*, 277 F.3d at 673 (noting that Ernst did not meet “this demanding threshold”).

148. *See id.* (concluding appellants’ claim that defendant had knowledge was unsupported by evidence).

which amounted to nothing more than mere second-guessing, an invalid ground for scienter.<sup>149</sup> Overall, the court gave substantial weight to the fact that “Ernst took reasonable steps to ensure the adequacy” of all Ikon accounts and that there is no evidence to suggest otherwise.<sup>150</sup>

#### IV. A GUIDE FOR PRACTITIONERS ON THE THIRD CIRCUIT’S TREATMENT OF SECTION 10(b)’S SCIENTER REQUIREMENT

Given the aforementioned precedent, it is going to be difficult for practitioners to successfully prove scienter in the Third Circuit.<sup>151</sup> The egregious accountant standard adopted by the Third Circuit appreciates the fact that GAAP is not an equation that, when applied to a scenario, will always yield the same result.<sup>152</sup> Because the Third Circuit recognizes that accounting is more like an art than a science, the court anticipates that two reasonable accountants will likely come up with two different results in conducting various aspects of an audit.<sup>153</sup> Accordingly, this court’s analysis demonstrates that the practitioner should not hope to succeed in a securities claim against an accountant just by showing that one account-

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149. *See id.* (noting appellants’ contention that \$20.8 million included \$4.2 million understatement in lease default reserve account did not rise to level of scienter according to court). The court stated that appellants purported to discern Ernst’s culpable state of mind from a draft and there is no evidence to suggest that Ernst did not take reasonable steps to ensure the accuracy of Ikon’s default reserves—this is not a material dispute with respect to scienter. *See id.* (finding no evidence that Ernst failed to attempt to ensure accuracy of client’s reserves).

150. *Id.* at 668 (describing Ernst’s reasonable conduct by mentioning “the magnitude of Ernst’s audit for fiscal year 1997”). Specifically, Ernst conducted six full scope audits, eight localized audits at Ikon business units that accounted for most of Ikon’s revenues, review procedures at Ikon’s corporate headquarters, reviews of previous years’ audits and external testing of Ikon’s account balances. *See id.* (specifying Ernst’s reasonable conduct); *see also In re Ikon Office Solutions, Inc. Sec. Litig.*, 131 F. Supp. 2d 680, 704 (E.D. Pa. 2001) (“[T]he general scope and nature of the audit work make it difficult to raise an inference of scienter, especially in light of the highly detailed documentary evidence of Ernst’s procedures, calculations and findings, which Ernst itself produced in the course of its audit.”).

151. For a discussion of scienter requirements in the Third Circuit, *see supra* notes 70-103 and accompanying text.

152. *See Thor Power Tool Co. v. Comm’r*, 439 U.S. 522, 544 (1979) (determining GAAP “are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions. . . . Rather, [they] tolerate a range of ‘reasonable’ treatments, leaving the choice among alternatives to management”).

153. *See Ikon*, 277 F.3d at 675 n.22 (stating that “a reasonable accountant may choose to apply any of a variety of acceptable procedures when preparing a financial statement”) (citing *Godchaux v. Conveying Techniquet, Inc.*, 846 F.2d 306, 315 (5th Cir. 1988)); *see also Ikon*, 131 F. Supp. 2d at 702 (recognizing that GAAP “tolerates a range of reasonable treatments”) (quoting *In re Cirrus Logic Sec. Litig.*, 946 F. Supp. 1446, 1457 (N.D. Cal. 1996)).

ant's figures differed from another's.<sup>154</sup> Instead, the Third Circuit's standard requires an egregious breach that signals an intent to defraud.<sup>155</sup>

By requiring a showing that an accounting firm's methods were unreasonable or grossly inconsistent with accepted accounting practices, the Third Circuit lessens the chance that an accounting firm will be the scapegoat when a company's financial status takes a sudden downturn.<sup>156</sup> This stance suggests that accountants are not supposed to be the end all and be all. Because their opinions only need be reasonable, the court is not saddling professionals, such as accountants, with complete responsibility when shareholders begin looking for a deep pocket.<sup>157</sup> The Third Circuit's position thus suggests that it may be more difficult in some instances to implicate an accounting firm because this standard requires a plaintiff to make an especially strong showing before scienter will be deemed present.<sup>158</sup> Nevertheless, the court expressed concern that it may be insulating auditors too much, especially crafty auditors who try to protect themselves from liability stemming from an audit by stating up front the potential risks that exist.<sup>159</sup>

Particularly relevant to the practitioner, the court clarified and simultaneously broadened the techniques that can be applied to prove scienter.<sup>160</sup> The court reiterated that circumstantial evidence can be used to establish scienter.<sup>161</sup> The court did not attempt, however, to limit the

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154. See *Ikon*, 277 F.3d at 677 ("A jury may not premise a finding of willful or knowing conduct to defraud or recklessness merely by judging between competing but nevertheless sound accounting methodologies."). The court noted: "[h]ighlighting different accounting methodologies that Ernst might have employed . . . does not suggest that the approach actually chosen was an extreme departure from ordinary care." *Id.*

155. For a discussion of the Third Circuit standard, see *supra* notes 85-103 and accompanying text.

156. See *Ikon*, 277 F.3d at 675 ("As there is no evidence to suggest Ernst's method . . . was unreasonable or grossly inconsistent . . . , there is no basis to conclude that Ernst fraudulently certified . . . the reserve.").

157. See *Pittsburgh Terminal Corp. v. Balt. & Ohio R.R. Co.*, 680 F.2d 933, 942-43 (3d Cir. 1982) (stating that where defendants intend consequences of their action, advice of counsel that they will not incur liability is not defense to Section 10(b) scienter requirement). The court's stance that reliance on advice of counsel is not a complete defense parallels the court's decision not to hold accountants liable for wrongdoings of their clients. See *id.* at 943 ("[W]here . . . [defendants'] know the materiality of the concealed information and intend the consequences of concealment, advice of counsel . . . cannot be recognized as a defense.").

158. See *Ikon*, 277 F.3d at 674 n.21 (noting that "the threshold for scienter is considerable").

159. See *id.* ("[W]e are wary to raise the bar even higher and insulate auditors who craftily choose not to memorialize confirmed problems or to qualify their observations with highly equivocal terms like 'risk,' 'potential,' and 'likelihood.'").

160. See *id.* at 667 n.7 (expanding techniques to prove scienter) (citing *McLean v. Alexander*, 599 F.2d 1190, 1198 (3d Cir. 1979)).

161. See *id.* (noting that, nonetheless, court rejects appellants' many attempts to use various circumstantial evidence to prove scienter) (citing *McLean*, 599 F.2d at 1198).



kind of circumstantial evidence used.<sup>162</sup> The court stated that circumstantial evidence is not limited to the examples in *McLean* (i.e., scienter can be proven by “accounting practices amounting at best to a pretended audit”), but rather plaintiffs can use “whatever means” to establish scienter.<sup>163</sup>

In addition, the court expressed distaste about using “discrete errors” discovered months after the completion of the actual audit work to demonstrate scienter.<sup>164</sup> Even though the court referred to the appellants’ attempt to pick apart the audit as “misshapen jigsaw pieces that collectively fail to reveal the picture embedded within the puzzle,” the court did not rule out using specific accounting violations collectively considered to prove scienter.<sup>165</sup> Practitioners should note that the court clarified that individual defects in the aggregate are one of the most plausible ways to prove that an accounting firm did not believe in the accuracy of its audit.<sup>166</sup>

Another consideration is that the court felt that Andersen’s reaching of the same decision not to restate the 1997 financials was “highly probative of the competence of Ernst’s 1997 audit opinion.”<sup>167</sup> This is so even though Andersen was not hired to review the 1997 opinion or financial statements for compliance with GAAP or GAAS but to be the Ikon board’s accounting expert in regard to its investigation of the Special Procedures.<sup>168</sup> Moreover, the court failed to consider that in reaching its opin-

162. *See id.* (“We did not intend in *McLean* . . . to restrict the scienter threshold . . .”).

163. *See id.* (holding that scienter can be proven in many ways). For a further discussion of circumstantial evidence, see *supra* notes 57-59 and accompanying text.

164. *See In re Ikon Office Solutions, Inc. Sec. Litig.*, 131 F. Supp. 2d 680, 703 (E.D. Pa. 2001) (noting that demonstrating Ernst’s scienter based only on discrete examples of poor auditing is more difficult because of vast scope of Ernst’s audit). For a further discussion of the court’s treatment of hindsight, see *supra* note 93 and accompanying text.

165. *Ikon*, 277 F.3d at 677 (concluding that specific allegations here did not rise to level of scienter).

166. *See id.* at 677 n.26 (explaining method to prove scienter). The court added:

We do not suggest, however, that individual defects in an audit could not, in the aggregate, create an inference of scienter, particularly at the summary judgment stage. To the contrary, in many cases the most plausible means to prevail on a section 10(b) claim against an auditor—without that ever-elusive “smoking gun” document or admission—will be to show how specific and not insignificant accounting violations collectively raise an inference of scienter.

*Id.*

167. *Id.* at 669 (stating that Andersen’s endorsement of Ernst’s audit “undermines any suggestion that Ernst could not reasonably have opined that IKON’s financial statements fairly presented its financial condition in accordance with GAAP”).

168. *See id.* at 669 n.11 (noting that before reviewing Ernst’s work, Andersen had to agree in writing not to report to Ikon’s board if it determined that 1997 audit violated generally accepted auditing standards).

ion, Andersen was merely relying on the work papers produced by Ernst.<sup>169</sup> Because Andersen was not even performing an audit of the 1997 opinion, the fact that Andersen agreed with Ernst's conclusions should not have been given so much weight by the court.<sup>170</sup> Nevertheless, the court's deference to a rival accounting firm's findings suggests another potential defense for accountants accepted by the Third Circuit.<sup>171</sup>

A practitioner should also consider that in *Ikon* the court was deciding whether there was a triable issue with respect to scienter sufficient to survive a motion for summary judgment.<sup>172</sup> The court recognized that a finding of scienter is very fact intensive and usually requires an assessment of witness credibility.<sup>173</sup> Nevertheless, it is significant that despite all of the appellants' allegations of fraud, the court did not think any of them was sufficient to warrant a jury's decision as to whether Ernst acted with scienter.<sup>174</sup> This demonstrates the difficult burden any plaintiff has of proving an accounting firm's scienter.

## V. CONCLUSION

The court in *Ikon* aligned the Third Circuit's standard for Section 10(b) scienter with the accountant's objectives in certifying a company's financial statements.<sup>175</sup> The court stated that because auditors are only required to express an opinion on the fairness of management's financial representations, an accountant's mere incorrect opinion is insufficient to demonstrate an intent to deceive, manipulate or defraud.<sup>176</sup> Moreover, the court clarified the precedent leading up to *Ikon* by establishing that a high degree of recklessness is required before scienter can be found. Consequently, practitioners will have a difficult time proving that discrete er-

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169. *See id.* at 669 ("Though not performing an outright audit . . . Andersen allocated hundreds of hours of labor to its examination of the work papers produced by Ernst in 1997.").

170. *See id.* (comparing number of hours Ernst worked on Ikon's 1997 audit (over 10,000) to "hundreds of hours of labor" that Andersen allocated).

171. *See id.* (concluding that no errors asserted by appellant indicate scienter).

172. *See id.* at 666 (noting that plaintiff need only show evidence sufficient to convince reasonable fact finder to find all elements of prima facie case).

173. *See id.* at 668 (stating that determination of scienter cannot often be undertaken appropriately on summary judgment proceedings).

174. *See id.* at 670 (holding that jury could not infer departure from standards of ordinary care based on evidence presented).

175. *See id.* at 673 (noting that "objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles") (citing *United States v. Weiner*, 578 F.2d 757, 786 n.27 (9th Cir. 1978)).

176. For a further discussion of the Third Circuit's approach as to what constitutes scienter, see *supra* notes 70-103 and accompanying text.

rors discovered in hindsight rise to the level of scienter.<sup>177</sup> Overall, the Third Circuit's stance indicates that it is providing protection for accounting firms from plaintiffs such as disappointed shareholders searching for a deep pocket.

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177. For a further discussion of the *Ikon* court's understanding of the term "recklessness," see *supra* notes 125-50 and accompanying text.